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Supreme Court, U.S.
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No. 00-1537

In The

Supreme Court of the United States

CITICORP NORTH AMERICA, INC. & AFFILIATES,

Petitioners,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

REPLY BRIEF FOR PETITIONERS

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RULE 29.6 STATEMENT

Petitioner Citicorp North America, Inc. is a wholly-owned subsidiary of Citicorp, which is a wholly-owned subsidiary of Citigroup Holdings, Inc., which is a wholly-owned subsidiary of Citigroup, Inc. Citigroup, Inc. is a publicly-held corporation.

During the 1985-1988 years in issue, the ownership of petitioner Citicorp North America, Inc. was as follows: During 1985-1987, petitioner Citicorp North America, Inc. and its predecessors (Citicorp Industrial Credit, Inc. and Citicorp (USA), Inc.) were wholly-owned subsidiaries of Citicorp Banking Corporation, which was a wholly-owned subsidiary of Citicorp. During 1988, petitioner Citicorp North America, Inc. was a wholly-owned subsidiary of Citicorp. Citicorp was a publicly-held corporation during all of 1985-1988.

Affiliates of petitioner Citicorp North America, Inc., who were California taxpayers during the 1985-1988 years in issue, as listed in the Appendix pages 102a-104a, were wholly-owned (directly or indirectly) by petitioner Citicorp North America, Inc. or its ultimate parent, Citicorp, during the 1985-1988 years in issue.

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REPLY BRIEF FOR PETITIONERS

Respondent essentially makes three points in its Brief in Opposition. First, it contends the case lacks ongoing national significance because California has since changed, on a prospective basis, the tax scheme at issue here. Brief in Opposition to Petition for Writ of Certiorari ("Br. Opp.") 11-12. Second, it contends this Court has already determined that subjecting the income of a unitary group to apportionment does not result in the taxation of extraterritorial income. Br. Opp. 12. Third, it contends that because California's method of taxation in this case apportions income to California in a fair manner, neither the anti-discrimination requirement nor the fair apportionment requirement of the Commerce Clause is implicated. Br. Opp. 21-25.

None of these points has merit. First, it is not true that issues raised here have "no ongoing legal significance in California." Br. Opp. 11. While it is indeed true that respondent recently amended the rules at issue here, it did so on a *prospective* basis. Thus, in addition to petitioner, other taxpayers in California face the same issue here on audit and in litigation. More importantly, however, is the ongoing *national* significance of the rule announced by the lower court. Four other States currently follow California's position in this case, and the lower court's opinion could embolden California to revert to its former position and other States to follow California's rule.

Second, respondent's attempt to cast this case as a challenge to the unitary or formula apportionment method ignores petitioner's central contention – that the State cannot arbitrarily shift income among corporations, by taking the California activities of nontaxable corporations and using them to assign income to taxable corporations, all under the guise of simply declaring all the corporations "unitary." Yet, this is precisely what respondent argues to this Court.

Third, respondent's rebuttal to petitioner's discrimination and fair apportionment claims disregards this Court's controlling Commerce Clause doctrine, and fails to respond to the incontrovertible fact that respondent's method of determining taxable income penalizes a corporation with affiliates that are *not* taxable by California and taxes petitioner on income that bears no relation to its (*i.e.*, the California taxpayer's) activities in the State.

In short, as we demonstrate below, an analysis of respondent's Brief in Opposition reinforces the case for granting a writ of certiorari.

I. THIS CASE HAS PROFOUND NATIONAL SIGNIFICANCE

Respondent's contention that this case "lacks sufficient importance" is without merit. Br. Opp. 13. The lower court's decision upholds a mechanism for determining a corporation's taxable income that allows California to shift income from a nontaxable affiliate to a taxable one – all under the guise of simply calling the corporations "unitary." The court's decision extends well beyond California to all States that impose a corporate income tax on a unitary basis. The decision allows respondent to tax the income of a nontaxable corporation engaged in a unitary business by shifting such income to an affiliate that is taxable. In effect, the rule established by the lower court is one of far-reaching import: once income has been properly apportioned to a State, the State is free to tax 100 percent of such income, even where a part of that income is attributable to a corporation that is not taxable and where in-state activities of a nontaxable corporation are used to assign income to a taxable corporation. Thus, even where a State cannot directly tax a nontaxable corporation, under the lower court's decision a State would be able to tax that corporation's income through the simple device of shifting the income to a taxable affiliate.

Moreover, there is no merit to respondent's contention that the lower court's decision is not a serious threat to constitutional restraints on state taxation. Br. Opp. 13-14. On the contrary, the decision nullifies the axiomatic principle of taxation that a State may not tax a person on income earned by another:

> We have no doubt that, because of the fundamental conceptions which underlie our system, any attempt by a state to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the Fourteenth Amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income.

Hoeper v. Tax Comm'n, 284 U.S. 206, 215 (1931).

Finally, respondent's attempt to minimize the national significance of this case is belied by the sheer number of court and administrative decisions from around the country that have considered the issues raised here,[1] and by the extraordinary interest this case has garnered among state tax practitioners and academics. Petition for a Writ of Certiorari ("Pet.") 24 n.9. In sum, the issues presented in this case are, and continue to be, truly "national" issues with profound ramifications upon the

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[1] *See, e.g., In re Taxpayer Corp.*, No. 90-027, Caseload No. 89261, 1990 Alas. Tax LEXIS 22 (Alaska Dep't of Rev., Sept. 17, 1990) (supporting petitioner's position); *Dover Corp. v. Department of Rev.*, 648 N.E.2d 1089, *appeal denied*, 657 N.E.2d 618 (Ill. App. 1995) (to the same effect); *Great N. Nekoosa Corp. v. State Tax Assessor*, 675 A.2d 963 (Me. 1996) (to the same effect); *In re Silver King Broad. of N.J., Inc.*, 1995 N.Y. Tax LEXIS 425 (N.Y.S. Div. of Tax App., Aug. 10, 1995) (to the same effect); *Emerson Elec. Co. v. Wasson*, 339 S.E.2d 118 (S.C. 1986) (to the same effect); *but see Airborne Navigation Corp. v. Arizona Dep't of Rev.*, No. 395-85-I, 1987 Ariz. Tax LEXIS 34 (Bd. of Tax App., Feb. 5, 1987) (supporting respondent's position).

manner in which states tax the income and activities of multistate taxable (and nontaxable) corporations.

II. CASES UPHOLDING THE UNITARY OR FORMULA APPORTIONMENT METHOD HAVE NO BEARING ON THE ISSUES RAISED HERE

Much of respondent's brief is devoted to the undisputed proposition that the unitary or formula apportionment method has long been upheld against challenges that it indirectly taxes extraterritorial income. Br. Opp. 14-16, 18-21. Respondent's goal in redirecting the inquiry is transparent: it seeks to place itself under the umbrella of this Court's decisions that have affirmed the settled proposition that including income of a unitary group in the preapportionment tax base does not constitute taxation of such income and that have affirmed the equally settled proposition that the use of formula apportionment methods is a valid method of determining income attributable to a State in light of the difficulty of ascertaining precisely what share of a unitary business's income should be apportioned to a State. However, as pointed out in the Petition and again below, neither the "unitary method" nor the preapportionment tax base is an issue in this case. The issues in this case surround respondent's claims it can tax income of a nontaxable corporation.

Respondent relies upon *Shell Oil Co. v. Iowa Dep't of Rev.*, 488 U.S. 19 (1988), and *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978). Br. Opp. 14-16, 18. However, respondent misreads *Shell Oil*, *Moorman*, and the other cases cited in its brief as supporting respondent's arbitrary reassignment of nontaxable income to petitioner. There is *no* dispute that income of Citibank (South Dakota), N.A. may be included in the preapportionment tax base, and there is *no* dispute that the three-factor formula employed by California apportions income that is related to the unitary group's activities in California. The issue here, however, is whether California can tax 100 percent of the income apportioned to this State when it is clear that

some of that *apportioned* income is attributable to a corporation that was immune from taxation. In other words, does the mere apportionment of income to a State give that State license to tax that income, or is the State required to determine whether it can tax that income after it is apportioned to the State? This is the fundamental question presented by this case, and that question has never been considered by this Court – in *Shell, Moorman,* or elsewhere.

The unitary method of taxation essentially involves a four-step process: first, the members of the unitary group are determined (Step One); second, the apportionable income of the unitary group is combined into a single "pot" of apportionable income (Step Two); third, an apportionment formula is applied to the "pot" of apportionable income to determine the income attributable to a particular State (Step Three); and fourth, the apportioned income is then assigned to the individual taxpayer entities producing that income (Step Four).

The cases cited by respondent address only the first three steps – who can be included in the unitary group (Step One) (Br. Opp. 14, *citing, e.g., Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298 (1994)); what income may be included in the pot to be apportioned among the States (Step Two) (Br. Opp. 15-16, *quoting Shell Oil Co.*, 488 U.S. 19); or the constitutionality of the apportionment formula (Step Three) (Br. Opp. 18, *quoting Moorman Mfg. Co.*, 437 U.S. 267). Specifically, respondent quotes from *Shell Oil Co.*, 488 U.S. at 30-31: "But income that is included in the preapportionment tax base is not, by virtue of that inclusion, taxed by the state" (Br. Opp. 15), and from *Moorman Mfg. Co.*, 437 U.S. at 273: "This method [unitary business formula apportionment] . . . is employed as a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State." Br. Opp. 18. The quoted language, however, simply has no bearing on the issues presented here. Respondent reads far too much into those

cases, declaring that *Shell Oil Co.* "implicitly" supports the income shift at issue here. Br. Opp. 16. *Shell Oil Co.* (as well as the other cases cited by respondent upholding the inclusion of nontaxable income in the preapportionment tax base) never implicitly (or even explicitly) considered the fundamental issue presented here, which is whether a State may tax income that is properly apportionable to California, but that is directly attributable to a corporation outside California's taxing jurisdiction. Thus, the authorities relied upon by respondent provide no support for its position in this case.

The arbitrary shifting of income in this case occurs in Step Four, after the unitary group's income has been apportioned to California. Under Step Four, if all corporations with California activities are taxable by the State, California assigns the apportioned income to each corporation on a pro rata basis. *See* Cal. Franchise Tax Bd., Legal Ruling No. 234, [1955-1959 Transfer Binder] Cal. Tax Rptr. (CCH) ¶ 201-418 (Oct. 27, 1959).[2]

However, if, as here, a corporation with California activities is *not* taxable by California, California then arbitrarily shifts that corporation's income to the other *taxable* corporations. *See* Cal. Franchise Tax Bd., Notice No. 90-3, [1991-1992 Transfer Binder] Cal. Tax Rptr. (CCH) ¶ 410-820 (June 8, 1990) (reproduced at App. 86a). It is this shifting of income that is the core issue in this case and that finds no support or justification in respondent's brief.

In sum, respondent's method of assigning income violates two core principles of taxation. First, it is well established that a State cannot tax through indirect means that which it cannot tax through direct means, *see, e.g., Passenger Cases*, 48 U.S. 283 (1849); *Hunt Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000). Second, it is equally

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[2] This ruling is available on respondent's website at http://www.ftb.ca.gov/legal/rulings/active/lr234.htm (as of June 6, 2001).

well established that a State may not tax a person or corporation on the income of another. *Hoeper*, 284 U.S. 206. Respondent has provided no effective rebuttal to these points.

III. RESPONDENT'S CONTENTIONS THAT THE TAX SCHEME AT ISSUE HERE DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE AND IS FAIRLY APPORTIONED ARE UNPERSUASIVE

A. Respondent Has Offered No Effective Rebuttal in Support of Its Discriminatory Tax Scheme

Respondent's primary defense against petitioner's assertion that its tax scheme discriminates against interstate commerce is that petitioner "ignores fundamental principles of combined reporting and reverts to the separate accounting principles which this Court has previously rejected." Br. Opp. 21. This rebuttal is wholly without merit, and is rather confusing.

First, "separate accounting" is not and never has been an issue in this case, because petitioner has never alleged that separate accounting principles should be used in this case. Indeed, petitioner prepared the returns at issue based on the unitary method. Respondent's rebuttal again demonstrates its attempt to redirect this Court's attention from the central issue in this case. Again, the central issue in this case is whether respondent can take income that has been apportioned to California and assign it all to taxable corporations, even though a part of such income is directly attributable to the California activities of a nontaxable corporation. This issue has no relation to separate accounting.

Second, respondent misconstrues unitary theory as permitting it to treat the unitary group as a single taxpayer rather than as merely a method of determining the income of each individual member of the unitary group. In this regard, respondent declares: "the *tax liability of a*

group of corporations engaged in a unitary business both within and without the state is appropriately measured not by reference only to the taxable status of individual members of the unitary business, but rather, by reference to the activities of the entire unitary group . . . . " Opp. Br. 22 (emphasis added). Respondent errs by assuming that unitary theory allows it to determine taxable income on a group basis. On the contrary, respondent's conception of unitary theory is directly at odds with the settled purpose of unitary taxation – *i.e.*, to determine the income attributable to a particular State. As the California Supreme Court observed, unitary theory "is not necessarily a disregard of the corporate entity nor an extension of the provisions of the statute by implication. Formula allocation is merely a method of ascertaining the true income attributable to the plaintiff's business." *Edison Cal. Stores v. McColgan*, 30 Cal. 2d 472, 481 (1947). Rather than providing a basis for respondent to tax the unitary group as if it were a single taxpayer, unitary theory is merely the means by which the income of a unitary group is divided among the States in which it does business. Unitary theory does not speak to whether a State can tax such income once it is apportioned, which is the issue here. Nor does unitary theory determine who is a "taxpayer."

Third, respondent's superficial attempt to distinguish *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), is also unavailing. Respondent contends that *Fulton* is not relevant because the "state taxing scheme condemned in that case did not arise in the context of the apportionment of income of a unitary business . . . . " Br. Opp. 22. Respondent apparently suggests that discrimination is acceptable as long as it arises in the context of an apportioned tax. Indeed, respondent confirms this by quoting, out of context, this Court's statement from *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 171 (1983), "[a]t least in the interstate commerce context . . . the anti-discrimination principle has not in practice required much in addition to the requirement of fair apportionment." Br. Opp. 23.

There is no substance to respondent's assertion on this point. In *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 399 (1984), the Court observed that " '[f]airly apportioned' and 'non-discriminatory' are not synonymous terms" in striking down a fairly apportioned New York income tax that was, nevertheless, unconstitutionally discriminatory. Indeed, the Court has flatly declared that "[e]ven if a tax is fairly apportioned, it may discriminate against interstate commerce." *Amerada Hess Corp. v. Director, Div. of Taxation*, 490 U.S. 66, 75 (1989).

Nor does respondent advance the analysis by suggesting that "when this apportionment method was applied to 'outbound sales,' it actually had the effect of *reducing* the income base of the taxable members of the group taxable in California." Br. Opp. 22. This observation is irrelevant to the question before this Court. Simply because the tax scheme at issue here treats taxpayers favorably in certain situations has no bearing on the question presented here where taxpayers are not treated favorably – whether the tax scheme penalizes petitioner for affiliating with corporations that engage in limited activities in California, and therefore are not taxable by the State.

B. Likewise, "Fair Apportionment" Is No Defense to the Constitutionality of the FTB's Method of Arbitrarily Reassigning Exempt Income

Once again, respondent bases its rebuttal on the contention that petitioner's case is founded on separate accounting principles: "[B]y attempting to attach income and apportionment factors to individual members of an integrated unitary business enterprise, Citicorp inappropriately injects separate accounting principles into the apportionment process." Br. Opp. 23. As discussed above, this contention is false and must be dismissed.

Respondent's arbitrary shifting of income from a nontaxable corporation to a taxable corporation cannot be saved by asserting that California has employed a fairly

apportioned tax scheme. It is not the isolated apportionment of income to California that implicates the Constitution here, but rather respondent's subsequent arbitrary shifting of the California income from nontaxable to taxable corporations. As a result of this shifting of income, the income assigned to petitioner does not "reflect a reasonable sense of how [petitioner's] income is generated." *See Container Corp.*, 463 U.S. at 169. The amount of income arbitrarily assigned to petitioner is completely unrelated to the extent of its activities in the State. The point to remember here is that respondent's method *increased* the tax liability on *all* the members of petitioner's unitary group which were California *taxpayers*, yet *none* of those California taxpayers' activities in California increased at all. The tax increase is due directly to respondent taking income attributable to the California activities of a nontaxable member of the unitary group (*i.e.*, Citibank South Dakota) and assigning that income to *California* taxpayers.

CONCLUSION

For the reasons set forth above, the petition for certiorari should be granted.

Respectfully submitted,

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